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SUBJECT: KANSAI ECONOMIC OUTLOOK: CONCERNS OF FLAGGING CONSUMER SENTIMENT DESPITE INVESTMENT BOOM

SENSITIVE BUT UNCLASSIFIED. NOT FOR INTERNET.

¶1. (SBU) Summary. The impact of rising commodity prices on consumer sentiment is the biggest threat facing the Kansai economy, according to a top official at the Osaka branch of the Bank of Japan. Meeting with EMIN May 23, BOJ Osaka Branch Deputy Director Kunio Matsuda said his greatest anxiety is that consumers will tighten their pursestrings in response to higher prices of food, gasoline and other necessities, knocking out one of the pillars of growth. Still, Matsuda was generally optimistic about economic prospects for the region that includes Osaka, Kobe, and Kyoto, pointing to large-scale plant investments by Sharp and other manufacturers and emphasizing the sometimes overlooked competitiveness of the area's large number and variety of small- and medium-sized enterprises (SMEs). Other Kansai-based interlocutors echoed Matsuda's views while adding corporate relocations from the region to Tokyo as another source of concern. End summary.

¶2. (SBU) Meeting with Embassy Tokyo EMIN and ConGen poloff May 23, Bank of Japan Osaka Branch Deputy Director Kunio Matsuda asserted the psychological impact of rising commodity prices on Japanese consumers is worse than current inflation data might suggest. He said the year-on-year price hike rate is only around 1 percent, but consumers feel as if it were 5 percent because they pay more at the supermarket and gas station even though the prices of big-ticket items such as PCs are unchanged. He said belt-tightening by inflation-wary consumers is the biggest economic risk for the Kansai region and Japan as a whole. Concern about inflation means the BOJ finds itself in unfamiliar territory after a decade of battling deflation, Matsuda added. The central bank now must be prepared to hike interest rates if oil prices trigger an inflationary spiral and to cut them if flagging consumer sentiment drags down the economy. Former BOJ Governor Toshihiko Fukui had an easier time than his successor, Masaaki Shirakawa, will, Matsuda suggested.

¶3. (SBU) Nevertheless, the BOJ official struck an optimistic note about the Kansai's economic prospects. He noted large-scale plant investment by manufacturers Panasonic and Sharp, the latter spending USD 4 billion to build the world's largest flat-panel display factory south of Osaka. Such investment, together with exports

to emerging markets in Asia, explains why the Kansai economy outperformed the national average in recent years. He expects that trend to continue, albeit at a slower pace, facilitated by the stability of banks in the Kansai. Unlike a decade ago, when failures rippled through the banking sector, lenders in the region are now in a position to support investment, he said.

¶4. (SBU) Matsuda played down notions the region is more vulnerable than others in Japan to competition from China and other low-wage countries, given the weight of manufacturing and prevalence of SMEs in the Kansai's economy. The share of manufacturing in the Kansai area is only 2-3 percent greater than in Kanto, Matsuda noted. Moreover, many SMEs are competitive technology-oriented firms, not the old-line suppliers or distributors that many imagine.

¶5. (SBU) While constituting an important part of the Kansai economy, SMEs get little more than lip service from local politicians, Matsuda continued. He said tax breaks and other measures to support SMEs are limited and limited in their effectiveness, a situation he described as unfortunate but difficult to change. He also criticized the GOJ's slowness in confronting the implications of Japan's aging population and expressed concern that Koizumi-era efforts toward decentralization and empowerment of the regions had been suspended under Fukuda.

¶6. (SBU) Finally Matsuda, talking about the GOJ's
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recent decision to block The Children's Investment Fund from increasing its stake in J-Power, acknowledged that the move sent a negative signal to foreign investors, but said he did not believe it was the start of a trend. Matsuda added he was encouraged by the resulting debate on Japan's openness to FDI.

¶7. (SBU) The central bank official's generally optimistic outlook was echoed by two Kansai-based interlocutors who met separately with EMIN on May 23: Takumi Hirai, an economic commentator and associate professor at Poole Gakuin University, and Mike Bobrove, head of the Kansai Chapter of the American Chamber of Commerce in Japan.

¶8. (SBU) Noting rising commodity prices and the stronger yen posed a double threat to Japan's long expansionary trend, Hirai forecasted a "soft landing" for the Kansai. He expects investment to remain high for the next quarter, and exports to the rest of Asia to be strong for the next two quarters.

¶9. (SBU) Hirai cautioned, however, that Kansai-area SMEs have not enjoyed significant economic spillover from the high-profile investments by Sharp and others. Furthermore, SMEs that supply the auto and electronics industries will face pressure to cut their prices from manufacturers trying to deal with higher raw materials costs. Nippon Steel, he said, will raise the price of the steel its supplies to Toyota by 30 percent, leading the carmaker to scale back its earnings forecast from 2.2 to 1.6 trillion yen.

¶10. (SBU) Hirai and Bobrove both said the Kansai economy continues to suffer from the relocation of the head offices of big-name companies to Tokyo, from Takeda Pharmaceutical and Nissin Noodles to Eli Lilly Japan. Hirai said corporate headquarters are centers of innovation, which means decisions to move corporate headquarters tends to shift those jobs from the region as well. Hirai also thought Kansai has done a poor job of promoting itself to foreign investors. While praising the region's economic diversity, Bobrove

conceded that he would set up his own company (a medical equipment supplier) in Tokyo if he could do it all over again. The reasons: to be closer to his biggest market and to regulators whose decisions have a direct impact on his business.

¶11. (U) This cable was cleared with Embassy Tokyo.

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